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Via Email:

The Honorable Vern Buchanan, Chair
Tax Reform Working Group on
Small Business/Pass Throughs
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Allyson Schwartz, Vice Chair
Tax Reform Working Group on
Small Business/Pass Throughs
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

Re: Comments to Small Business/Pass Throughs Working Group

Dear Representatives Buchanan and Schwartz:

I am writing on behalf of various clients consisting of family-, employee-, and other closely-held corporations. These clients wish to submit three proposals to be considered by the Tax Reform Working Group on Small Business/Pass Throughs. Each of these proposals is discussed below.

Eliminate Restriction on Number of S Corporation Shareholders

Under section 1361,¹ to be eligible to elect S corporation status, a corporation may not have more than 100 shareholders. For this purpose, a husband and wife and all members of a family (which includes a common ancestor and any lineal descendant up to six generations removed) are treated as one shareholder. Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted to be shareholders

¹ All "section" references are to the Internal Revenue Code of 1986, as amended (the "Code").

of an S corporation. Although the Code limits the number and types of shareholders an S corporation may have, there is no limit on the size of an S corporation's business.

The limitation on the number of shareholders of an S corporation is nothing more than a historical artifact. In 1958, when Congress first enacted subchapter S of the Code, S corporations were permitted to have only ten shareholders. Since that time, Congress has repeatedly eased that limitation. In 1996, when Congress expanded the number of eligible shareholders from 35 to 75 in the Small Business Job Protection Act, Congress recognized that "increasing the maximum number of shareholders of an S corporation will facilitate corporate ownership by additional family members, employees and capital investors."² That same reasoning applies today. It is particularly true with respect to employee- and investor-owned S corporations. While the family attribution rules allow potentially hundreds of shareholders of family-owned S corporations, employee- and investor-owned S corporations continue to face burdensome restrictions on the number of shareholders. Congress should once again recognize that such restrictions do not further any particular tax policy, but restrict the growth of many S corporations' businesses.

If Congress seeks to limit the number of shareholders of an S corporation, it should not do so by picking an arbitrary number, but should instead refer to more meaningful distinctions, such as whether the corporation's stock is publicly-traded, similar to rules governing partnerships under section 7704 and as outlined in Option 2 to the *Technical Explanation of the Ways and Means Committee Discussion Draft Provisions to Reform the Taxation of Small Businesses and Passthrough Entities* (the "Discussion Draft").

Permit Nonresident Alien Shareholders of S Corporations

Section 1361(b)(1)(C) provides that nonresident aliens are not permissible shareholders of an S corporation. Similar restrictions apply to beneficiaries of trusts that are shareholders of an S corporation. Like the limitation on the number of shareholders, the prohibition against nonresident alien shareholders needlessly hinders many S corporations' expansion and also creates traps for the unwary. In today's increasingly international economy, S corporations should not be prohibited from admitting nonresident alien family members, employees, or investors as shareholders.

If nonresident aliens are permitted to become S corporation shareholders, Congress should also amend section 1446 to require withholding on nonresident alien shareholders just as nonresident alien partners are subject to withholding today. The regulatory regime for withholding on nonresident alien partners under section 1446 and related provisions can be easily be amended to accommodate nonresident alien shareholders of S corporations.

² S. Rep. No. 104-281 at 45 (1996).

Permit Federal Composite Returns for Pass Through Entities

If, as recommended above, Congress expands the permissible number of S corporation shareholders, Congress also should allow such corporations to file a composite Federal income tax return on behalf of their shareholders. The ability to file a composite return on behalf of shareholders also would greatly enhance the feasibility of unified rules for pass through entities, as outlined in Option 2 in the Discussion Draft.

A composite return would allow the corporation to act on behalf of the electing shareholders to compute the amounts of the corporation's income attributable to each shareholder and pay the aggregate tax liability of the electing shareholders within a specified rate structure. May states allow partnerships to file composite returns on behalf of electing partners. Such returns significantly reduce administrative burdens on partnerships, electing partners, and the state tax agencies, while efficiently collecting taxes due. Congress should adopt similar rules for pass through entities at the Federal level.

* * *

We look forward to the Working Group's progress on expanding the availability of pass through taxation for more and larger businesses. Please contact me if you have any questions relating to the proposals described herein.

Sincerely,

A handwritten signature in black ink, appearing to read "Joshua T. Brady", with a stylized, cursive-like script.

Joshua T. Brady